

Office of Chief Counsel  
Internal Revenue Service

# memorandum

CC:MSR:ILD:TL-N-7547-98

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G:\CASES [REDACTED]

date: September 24, 1999  
to: District Director, Illinois  
Attn: Mike Rich, Case Coordinator E:1202

from: District Counsel, Illinois CC:MSR:ILD

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subject: Sale of [REDACTED]

Taxpayer: [REDACTED]

Mailing Address: <not stated>

EIN: [REDACTED]

Years: [REDACTED]

POA: <none>

## I. Issue

Should the taxpayer be permitted to amend its [REDACTED] return (1) to reflect a later year reduction in the sales price of stock in a subsidiary, based on an "adjustment to purchase price" clause in the sales contract, and (2) to allow a deduction for state taxes resulting from the determination that the taxpayer was responsible for state taxes owed by the subsidiary.

## II. Conclusion

The taxpayer should not be permitted to amend its return for [REDACTED] to adjust the purchase price. The mitigation provisions of the Code could afford relief for the year of repayment, depending on how the computation under § 1341 works out. However, a deduction for the state taxes can be accrued on the [REDACTED] consolidated return.

## III. Facts

[REDACTED] is an accrual basis taxpayer. It sold [REDACTED] percent of the stock of [REDACTED] to [REDACTED] for \$[REDACTED] on [REDACTED] subject to adjustment based on a final balance sheet determination of the net equity of [REDACTED] made an IRC § 338(h)(10) election, and reported a gain on the sale.

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<sup>1</sup> This was the closing date; the purchase date was "as of" [REDACTED]

Section 2.4 of the sales agreement provided:

2.4 Adjustment of Purchase Price. (A) Seller shall pay to Buyer, as an adjustment to the Purchase Price, in the manner and with interest as provided in Section 2.4(b), the greater of (x) the amount by which Final Working Capital is less than \$ [REDACTED], if any, and (y) the amount by which Final Stockholder's Equity is less than \$ [REDACTED], if any. Buyer shall pay to Seller, as an adjustment to the Purchase Price, in the manner and with interest as provided in Section 2.4(b), the amount by which Final Stockholder's Equity is greater than \$ [REDACTED] if any. If payments are required to be made by both Buyer and Seller pursuant to the preceding two sentences, the party owing the larger of the two amounts shall pay the difference.

On [REDACTED], [REDACTED] presented a Closing Balance Sheet to [REDACTED] asserting that it was due an adjustment of \$ [REDACTED]. This amount was evidently in addition to the amount that [REDACTED] had evidently agreed to as an adjustment, in the amount of \$ [REDACTED].<sup>2</sup> The parties were unable to agree on the § 2.4 adjustment, and the matter went to arbitration.

In addition to the § 2.4 adjustment, [REDACTED] claimed that [REDACTED] owed it an amount for certain state taxes which had been treated by [REDACTED] as attributable to the period after the sale of the stock. [REDACTED] had filed a [REDACTED] consolidated return including [REDACTED] and that return did not reflect a deduction for the state taxes. These taxes were attributable to the deemed [REDACTED] sale of assets under § 338(h)(10), and so far as we know, they were paid in due course by [REDACTED] presumably on a return filed sometime in [REDACTED].

In [REDACTED], the arbitrator ruled that [REDACTED] owed [REDACTED] \$ [REDACTED] consisting of (1) a "Balance Sheet" adjustment of \$ [REDACTED] and (2) \$ [REDACTED] in a dispute over state taxes paid by [REDACTED]. [REDACTED] also was liable to pay interest of \$ [REDACTED].

The Balance Sheet adjustment was based on the arbitrator's conclusions concerning a variety of items involving inventories, reserves, book values, returns and so forth. The state taxes were deemed to have been required to be paid as a result of the § 338 election made by [REDACTED].

[REDACTED] has filed a Form 1120X amending its [REDACTED] return to reduce the reported purchase price by \$ [REDACTED], and to accrue a deduction of \$ [REDACTED] for the state taxes.

#### IV. Discussion

Under the "claim of right" doctrine, if a taxpayer receives earnings under claim of right and without restriction as to its disposition, it has received income which it is required to report for income tax

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<sup>2</sup> It is our understanding that this \$ [REDACTED] was reflected on the [REDACTED] return as an adjustment to the purchase price, and is not in issue at this point.

purposes, even though it might still be claimed that it is not entitled to retain the money, and even though it might still be adjudged liable to restore its equivalent. Should the taxpayer later restore the money, perhaps it would be entitled to a deduction in the year of repayment. *North American Oil Consolidated v. Burnett*, 286 U.S. 417 (1932).

In this case, [REDACTED] contends that it did not hold the amounts ultimately paid under the arbitrator's decision under a claim of right. It maintains that the proceeds were not subject to claim of right, because "the final amount of balance sheet adjustments required by the contract. could not be determined until after year-end." [REDACTED] maintains that it did not dispute that it was required to refund a portion of the proceeds, and that it understood that it did not have an unrestricted right to the amount received in [REDACTED].

(1) Balance Sheet Adjustments - \$ [REDACTED]

With respect to the Balance Sheet adjustments, as you point out in the RAR, the taxpayer's obligation, if any, to pay any amount back to [REDACTED] was contingent on the working capital and stockholder equity falling under certain minimums, and the existence of that contingency was, in fact, disputed by [REDACTED]. [REDACTED]'s contention is that it did not disagree that it owed [REDACTED] something, but merely disagreed about the interpretation of the language in the sales contract which dealt with the manner for determining what the ultimate sales price, and thus the adjustment, would be. We do not see how that is any different than disputing [REDACTED]'s claim to the right to an adjustment.

As formulated in *North American Oil*, the claim of right doctrine has three basic elements: (1) receipt by a taxpayer of money (or other property,) (2) control by the taxpayer over the use of the money, and (3) assertion of some claim of right or entitlement by the taxpayer to the receipt of the money. These conditions are all satisfied in the present case, and consequently it is our view that the taxpayer properly reported the entire amount of the sales price as income.

Because the taxpayer was required to return the amount involved with the Balance Sheet Adjustments, relief under I.R.C. § 1341 might be available, depending on the way the computation works out.. Section 1341 provides relief to a taxpayer who in an earlier tax year includes in gross income an item of income received under a claim of right and in a later tax year is required to repay that amount. Section 1341 applies if (1) an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable for the later taxable year because it was established after the prior year that the taxpayer did not have an unrestricted right to the item or a portion thereof; and (3) the deduction exceeds \$3,000. §1341(a).

If these conditions are met, as they appear to be here, the taxpayer is permitted to recover the excess tax, if any, paid on the item resulting from the change in tax rates between the earlier year and the later year. *Maier Brewing Company v. Commissioner*, T.C. Memo 1987-385. However, the loss involved is capital in nature, and whether relief is available depends on the taxpayer's tax situation as of the year of repayment.

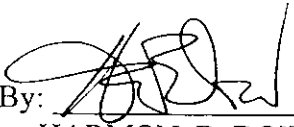
## (2) State Tax Liability - \$ [REDACTED]

The taxpayer claims that the decision of the arbitrator that it had to pay the taxes means that any reimbursement to the buyer has the effect of increasing [REDACTED]s, and hence, [REDACTED]s, [REDACTED] state tax liabilities, which are deductible in [REDACTED]. We agree with the taxpayer.

[REDACTED]'s payment to [REDACTED] of \$ [REDACTED] should be characterized as a capital contribution by [REDACTED] to [REDACTED], which never left the group, since a § 338(h)(10) election was made; it simply liquidated into [REDACTED]'s tax items should be included in the seller's return for the [REDACTED] because [REDACTED] never left the [REDACTED] group and therefore continued on [REDACTED]'s consolidated [REDACTED] return. Therefore, the \$ [REDACTED] should be allowed as an accrual on the taxpayer's [REDACTED] consolidated return as a deduction for taxes owed to the state, absent some other reason to disallow the accrual to [REDACTED].

This opinion was informally coordinated with Grid Glycer in our National Office, and is subject to 10 day post-review in Field Service. We will advise you if any changes or additions result from that review.

Richard A. Witkowski  
District Counsel

By:   
HARMON B. DOW  
Special Litigation Assistant

cc: Assistant Chief Counsel (Field Service) CC:DOM:FS  
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